FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C.

In the Matter of THE GREENE COUNTY BANK STRAFFORD, MISSOURI (Insured State Nonmember Bank)	FDIC-93-160b DECISION AND ORDER

STATEMENT OF THE CASE

1. Introduction

This matter is before the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") for review of the Recommended Decision of Administrative Law Judge Arthur L. Shipe ("ALJ") dated October 31, 1994.[1] The ALJ recommended that no cease and desist order issue against The Greene County Bank, Strafford, Missouri ("Bank"), and FDIC Enforcement Counsel filed Exceptions. After submission of the case to the Board, the FDIC's Acting Executive Secretary, pursuant to delegated authority, under the advice and recommendation of the General Counsel, issued an order reopening and seeking supplementation of the record. Additional information was submitted by the Bank on May 1, 1995.

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[1] Citations to the Recommended Decision shall be "R.D. at ___." "Ex." citations are to the Exhibits admitted into evidence by the ALJ. "Tr." references are to the testimony at the hearing before the ALJ.

This case involves the propriety of certain futures transactions in which the Bank engaged. Such transactions, which can be an effective tool for controlling interest rate risk, can also present significant risks if a financial institution does not exercise a great deal of care. Frequently, these transactions can raise critical issues concerning suitability, prior approval, recordkeeping, and separation of functions for financial institutions involved in them. This case is the first one to come before the Board involving the use of futures to hedge interest rate risk, and the FDIC has not recently issued guidance on this subject.

As set forth below, the Board agrees with many of the ALJ's factual findings. However, the Board is troubled by some of his discussion of the issues and his ultimate decision not to issue a cease and desist order, even one less onerous than the 25-page proposed order submitted by FDIC Enforcement Counsel, in light of his findings of fact. After a full, independent review of this record in its entirety, the Board concludes that a cease and desist order should issue and reverses the ALJ's decision. However, the Board declines to adopt the order proposed by FDIC Enforcement Counsel in favor of a more modest order that properly recognizes both the progress the Bank has made in dealing with interest rate risk and the validity of some of FDIC Enforcement Counsel's criticisms of the Bank's conduct.

2. Procedural Background

The case arises out of the issuance of a Notice of Charges and of Hearing dated July 26, 1993 ("Notice") to

initiate a proceeding for the purpose of determining whether an order should be entered against the Bank pursuant to section 8(b) of the Federal Deposit Insurance Act ("FDI Act"), 12 U.S.C. § 1818(b). The Notice was based on alleged unsafe and unsound practices arising out of the Bank's transactions in financial futures and its liquidity position.

The Bank contested the Notice, and a hearing took place before the ALJ on January 24-27, 1994. After post-hearing briefs were filed, the ALJ issued his Recommended Decision declining to issue a cease and desist order on October 31, 1994.

Thereafter, FDIC Enforcement Counsel filed Exceptions to the Recommended Decision. On March 21, 1995, the FDIC's Acting Executive Secretary, pursuant to delegated authority, under the advice and recommendation of the General Counsel, issued an order reopening the record so that the parties could submit additional information on three issues identified in the order. The Bank submitted a Supplemental Brief dated May 1, 1995. FDIC Enforcement Counsel has filed objections to the order and the Bank's Supplemental Brief but has not otherwise responded to the order.[2]

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[2] This Board fails to understand the basis of FDIC Enforcement Counsel's.objection. Certainly FDIC Enforcement Counsel cannot be suggesting that this Board lacks the authority to seek information which it deems necessary for it to reach a fully informed decision on the merits in this proceeding.

3. Pertinent Facts

a. The Bank and its interest rate risk problem

The Bank is small and, in recent years, has had less than $20 million in assets. R.D. at 3. At the time of the hearing, assets totalled $16.5 million. *Id.* A substantial portion of the assets consists of long-term securities. R.D. at 5. The Bank has maintained stable earnings and adequate capital at all pertinent times. R.D. at 73-74, 101, 103.

The Bank is essentially a one-person operation run by its president, Bernard H. Rullman, Jr. R.D. at 3. He and his wife own the holding company that owns the Bank. *Id.* Mr. Rullman is clearly a knowledgeable individual and successful banker, but, as the ALJ noted, "he seems to listen to his own drummer in banking matters." *Id.* As a result, he has had difficulty in carrying out the Bank's obligations under applicable FDIC policies and the Memorandum of Understanding ("MOU") entered into with the FDIC and the State of Missouri regarding, *inter alia*, the Bank's investments in futures contracts as a way to reduce interest rate risk.

Some interest rate risk is inherent in commercial banking. R.D. at 75. Historically, the Bank has had significant and above normal balance sheet exposure to interest rate risk, as noted by the FDIC's Report of Examination dated December 8, 1989, and all of the subsequent examinations, although its position has improved. R.D. at 82-83, 84, 86, 87. Its balance sheet is highly "liability sensitive" in that an increase in interest rates will cause it to have increased interest expenses without a corresponding increase in interest income and thereby lower the net interest income for the period. R.D. at 78.

This interest rate risk presents a threat to the Bank if not properly addressed. One of the methods of reducing the risk is to engage in "hedging" with financial futures contracts. R.D. at 92. A hedge transaction involves offsetting a risk in one market – in this case the risk that an increase in interest rates will increase the cost of the Bank's liabilities – by taking on the opposite risk in the futures market. *See id.*[3] If the hedge is constructed properly, increased costs of the Bank's liabilities will be offset by gains in the futures transactions. *See* R.D. at 33. Conversely, a lowering of the costs of the Bank's liabilities will be offset by losses on the futures. The primary issue in this case is the manner in which the Bank has confronted its interest rate risk by using such futures.

b. The Bank's initial effort to address interest rate risk

Prior to the February 26, 1991 examination, the Bank had made no attempt to address interest rate risk despite the FDIC's recommendations to do so. R.D. at 82-83. However, on April 23, 1991, the Bank adopted a Funds Management & Investment Policy ("Policy") dealing with interest rate risk. R.D. at 83. The Policy did little more than generally authorize the Bank to invest in futures, limited those investments to an amount equal to total loans and investments, and delegated implementation to the Asset/Liability Committee ("ALCO"). Ex. 16-b-2. On June 27, 1991, the Bank's Board of directors ("Board")

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[3] The ALJ's Recommended Decision contains a very good discussion of hedging using futures. R.D. at 91-92.

authorized the Bank to enter into futures contracts with brokerage firms for the purpose of hedging. R.D. at 93; Ex. 266.

In September 1991, the Bank acquired 80 short futures contracts. R.D. at 93. The acquisition of the first 20 contracts occurred on September 9, 1991, prior to any discussion by the Bank's board. R.D. at 94. On September 10, 1991, the Bank's board did discuss the mechanics of hedging using financial futures and the acquisition of further contracts. R.D. at 94-95. Thereafter, the Bank acquired the other 60 contracts. R.D. at 93. In addition, the Bank sold a "naked call option." R.D. at 93-94.[4] Beginning September 1991, the Bank acquired more and more futures contracts and, as of October 27, 1993, held 240 contracts of which 160 were short and 80 were long. R.D. at 96-98.

c. The Memorandum of Understanding

On August 9, 1991, prior to the acquisition of the first futures contracts, the FDIC had brought proceedings against the Bank under section 8(b) of the FDI Act because of the unaddressed interest rate risk exposure. R.D. at 6. In settlement of that proceeding, on February 14, 1992, the Bank executed the MOU, and that document is at the heart of this case. R.D. at 8. The most relevant

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[4] There is no question that this investment was speculative and not part of the hedging program. R.D. at 45-46. It exposed the Bank to the possibility of substantial losses; fortunately, however, the Bank incurred no loss, and never engaged subsequently in any similar transactions. *Id.* at 46.

portions are set forth verbatim in the Recommended Decision at pages 8-9. Essentially, the MOU required the Bank to develop a detailed written plan for dealing with interest rate risk exposure and a detailed written policy governing the use of futures to reduce interest rate risk. R.D. at 8. Among other things, the MOU mandated:

> (1) specific identification of the assets or liabilities to be hedged including the amount and desired maturity of the hedge;
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> (2) selection of appropriate futures contracts based on a correlation analysis and continued analysis and verification of the correlation on a monthly basis;
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> (3) identification of the exposure to be hedged, i.e., the "gap";[5]
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> (4) determination of the effective cost of the hedge and whether hedging is a cost-effective alternative;
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> (5) determination of the number of contracts needed to cover the identified exposure; and
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> (6) determination of the change in market value of the futures contracts if there is a 300

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[5] Gap analysis" is a method of determining the extent of interest rate risk exposure. The ALJ's Recommended Decision contains a very thorough explanation of the method of calculation involved. R.D. at 13-14, 76-79. Gap analysis is not the.most sophisticated method for determining interest rate risk, R.D. at 14-15, 79-80, but it is used by FDIC examiners apparently because they can perform the calculations easily based on information provided by the bank, Tr. 78. If the institution being examined has performed a more sophisticated analysis, such as duration or simulation analysis, the examiners will consider the results of that analysis. R.D. at 79-80.

> basis point change in the underlying interest rate of the contracts.

Ex. 13, p. 1. The MOU incorporated by reference the requirements of the FDIC's *Statement of Policy Concerning Interest Rate Futures Contracts, Forward Contracts and Standby Contracts,* 44 Fed. Reg. 66673 (Nov. 20, 1979), *as amended,* 45 Fed. Reg. 18116 (March 20, 1980), *as amended,* 46 Fed. Reg. 51302 (Oct. 19, 1981)("FDIC Policy Statement"). Ex. 13, pp. 6-8. While the MOU reflects and implements the FDIC Policy Statement in many ways, the FDIC Policy Statement contains additional requirements including maintenance of general ledger memorandum accounts or commitment registers to keep an account of the futures contracts and the establishment of internal controls, segregation of duties, and internal audit programs.

d. The Bank's efforts to comply with the MOU

On March 11, 1992, the Bank transmitted to the FDIC a packet of documents apparently designed to implement the MOU. Ex. 15. The most important of these was entitled the *Asset/Liability Policy Management Statement* ("Policy Management Statement"), approved by the board on December 30, 1991. R.D. at 26. It set up the ALCO (although that body had apparently already been set up by the April 23, 1991 Policy) and delegated to it the responsibility for implementation of the Policy Management Statement.[6] With regard to interest rate risk, the

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[6] The ALCO's four members constituted four of the five members of the Bank's board. R.D. at 26.

Bank set a policy of ensuring that an adverse change in interest rates of 200 basis points would not reduce average net income by more than 50 percent. Ex. 15, p. 12. This goal was to be achieved by limiting the three month and one year gaps to a minus 40 percent of assets. *Id.* The Policy Management Statement authorizes the use of financial futures contracts to manage the Bank's exposure to interest rate risks, *id.*, p. 13, and requires the ALCO to perform the determinations and calculations identified in the MOU if financial futures are used, *id.* p. 14.

The March 11, 1992 transmittal also enclosed an unsigned copy of the minutes of the ALCO for February 23, 1992. *Id.*, p. 16. The ALCO minutes included calculations purporting to show that a total of 100 futures contracts would be needed to fully hedge the Bank's liabilities; however, the ALCO determined to maintain the current position of 80 contracts as a sufficient hedge. A signed version of these minutes calculates at 122 the number of contracts necessary to effect a full hedge. Ex. 32, p. 2.[7]

Another document enclosed in the transmittal, entitled *Greene County Bank Interest Rate Strategy,* contained calculations showing that 70 contracts would be adequate to totally hedge the Bank's liabilities for one year. Ex. 15, p. 17. Finally, the transmittal included some regression

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[7] A signed version of the minutes with the 100 contracts calculation also exists in the record. Ex. 21-b-4, p. 2.

analyses showing the high correlation between the T-Bill futures and the Bank's liabilities. *Id.*, pp. 18-21.[8]

Pursuant to the MOU, the Bank submitted monthly reports. R.D. at 102-03. Some of the early monthly reports (prior to November 1992) contain the results of regression analyses concerning the correlation between the Bank's liabilities and the futures chosen as a hedge. Exs. 217, 219, 221, 224, 225. However, the later reports do not include this information although it was apparently available.[9]

The Bank did not calculate interest rate risk on a regular basis during the period at issue; however, it received further information on interest rate risk in the form of gap analyses from Reports of Examination issued by the FDIC and the State of Missouri. R.D. at 39.[10] Moreover, information on interest rate risk and hedging was also presented in an analysis done for the Bank by IBAA Securities in June 1992. Ex. 30. That report contained a gap analysis and concluded that the Bank "give

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[8] KPMG Peat Marwick had previously done a study for the Bank in December 1991 showing that correlation. R.D. at 95.

[9] Beginning in early 1992, Mr. Rullman produced a monthly report (Ex. 279) for the ALCO on his computer that described the Bank's current futures positions, determined gains and losses on the positions, and included a regression analysis. R.D. at 43.

[10] Just prior to the hearing, Mr. Rullman performed an interest rate risk calculation based on proposed federal regulations, *Risk-Based Capital Standards: Interest Rate Risk*, 58 Fed. Reg. 48206 (Sept. 14, 1993). R.D. at 16-19. He also performed other interest rate risk calculations in late 1993 (Ex. 268A, 268B, 268C). Tr. 831.

consideration to reducing the number of T-Bill contracts. . . . it appears that only forty contracts would be needed to hedge your negative gap of approximately $10 million." *Id.* at p 21.[11]

e. The Bank's acquisition of spread positions

As noted above, the Bank began to acquire spread positions in late 1992. The strategy the Bank has pursued appears to leave the basic 80 short contract hedge in place, while the Bank acquired some long and an additional but equal number of short contracts of different maturities from the long contracts. R.D. at 96-97.

Nothing in the policy documents generated to comply with the MOU (Ex. 15) specifically authorizes the acquisition of long futures or of derivative instruments not designed to hedge interest rate risk exposure. The record contains an undated document purporting to justify the initial investment in long contracts as a way of cutting the costs of the hedge strategy. Ex. 21-b-5. Based on that document and the testimony of Mr. Rullman, Tr. 800-04, the strategy for acquiring long contracts and short contracts of differing maturities appears speculative: an attempt to take advantage of the spread between the long and short contracts to create income that could be used to offset the cost of the basic hedge. The acquisition of the

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[11] The FDIC's Examiner-in-Charge for the Bank also testified that the Bank's futures position had remained constant even though its interest rate risk exposure had declined over the period at issue. Tr. 533.

spread positions was not designed to hedge interest rate risk. R.D. at 41-42.

Neither the minutes of the ALCO nor those of the board clearly show approval of the strategy at the time of the initial investment. Exs. 31, 32. The first apparent approval of acquisition of long contracts is contained in the ALCO minutes dated March 29, 1993, several months after the initial investment. Ex. 32, p. 15. Fortunately, the Bank incurred no net losses as a result of these investments. R.D. at 41.

f. Mr. Rullman's role

Mr. Rullman clearly has played the dominant role in the Bank in trading futures and securities. R.D. at 44-45.[12] There is no segregation of duties or internal audit program in the Bank to act as an independent check on Mr. Rullman. R.D. at 45; Tr. 356. At least two sets of the minutes indicate that the ALCO delegated to Mr. Rullman the decision on whether or not to increase the hedge

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[12] The Bank's purchase of a Real Estate Mortgage Investment Conduit ("REMIC") security (more generally known as a collateralized mortgage obligation or CMO) appears to have been arranged by Mr. Rullman without a full-blown analysis or ALCO or board of directors approval. R.D. at 49-50. Under certain circumstances, apparently not present in this case, a REMIC would be a "high-risk mortgage" security and might be an improper investment under federal guidelines. R.D. at 104. *See Supervisory Policy Statement on Securities Activities*, 57 Fed. Reg. 4028, 4037-38 (Feb. 3, 1992). However, the Bank sustained no loss on this investment. *Id.* at 50.

position. Ex. 32, pp. 10-11.[13] Moreover, at least one member of the Bank's board and ALCO committee was unclear about the reason for the increases in the Bank's futures positions. Ex. 27; Tr. 430-32. Up to the time of the issuance of the Notice, however, the hedging program had been successful in controlling the Bank's interest rate risk exposure. R.D. at 99. The spread positions, although not part of the hedging program and, therefore, speculative, have provided income to offset the costs of that program. R.D. 100-01.[14]

4. The ALJ's Decision

The ALJ issued a lengthy and careful Recommended Decision. Most of the facts just set forth are among those found by the ALJ. As noted above, he declined to institute a cease and desist order. With respect to specific investments he concluded that:

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[13] In fact, all of the minutes tend to be very cryptic concerning futures and securities matters, although it is reasonable to infer from the language in the ALCO minutes that the monthly analyses performed by Mr. Rullman using his computer program, *supra*, note 9, were presented at the ALCO meetings.

[14] The Bank's liquidity position has been a matter of some concern. Its short term assets are a small percentage of its short term volatile liabilities, R.D. at 90-91, leaving open the possibility that a decline in deposits caused by rising interest rates could create a liquidity problem. However, the Bank's liquidity position is strengthened by the availability of appreciated securities and credit lines at other banks. R.D. at 50, 91.

(1) the sale of naked call options was an unsafe and unsound practice but had not resulted in losses and had not been repeated, R.D. at 45-46, 106;

(2) the purchase of the REMIC was not an unsafe and unsound practice in that it was not a "high risk security" under FDIC guidelines and resulted in no loss to the Bank, R.D. at 104, 106;

(3) the acquisition of the spread positions, although arguably speculative, offset most of the expenses of the hedging program and was consistent with the Bank's investment policy, R.D. at 40-43, 101; and

(4) the Bank's hedging strategy involving the use of short futures contracts to hedge short-term liabilities was appropriate, effective and entailed little risk to the institution, R.D. at 98, 99.

In addition, he concluded that the Bank was in substantial compliance with the MOU and the FDIC Policy Statement concerning futures: (1) "The bank has complied with the MOU in material respects but it has not adopted an investment policy in full compliance with paragraph 1(c) of that agreement," R.D. at 106, and, (2) the "substance" of the FDIC's Policy Statement on futures had been adopted by the Bank, R.D. at 26. For these reasons he declined to recommend imposition of a cease and desist order.

The ALJ carefully considered the Bank's attempt to comply with each provision of the MOU and Policy Statement. He found that the Bank had policies governing futures investments. R.D. at 23-24. He relied on the Funds Management and Investment Policy approved by the

Bank's board of directors on April 23, 1991, as authorizing investments in futures and setting a limit on the futures of an amount equal to total loans and investments. *Id.* He noted that although the first purchase of short futures occurred without specific board approval, the board apparently discussed and approved subsequent purchases at the September 10, 1991 meeting. R.D. at 24-25. Later, in his view, ALCO became responsible for and did develop policies. R.D. at 26. He also concluded that calculations contained in the ALCO minutes of February 23, 1992, provided limitations on the amount of futures the Bank could acquire and determined the proper hedge ratio. R.D. at 27-30.

The ALJ concluded that the risk to be hedged was adequately identified because of the repeated gap analyses performed by the examiners and IBAA Securities. R.D. at 39-40. He also found that the futures chosen to hedge the risk were appropriate, and that the Bank had performed monthly correlations to verify the continuing appropriateness of the use of those futures. R.D. at 32-33. Finally, with regard to the MOU requirement that cost-effectiveness of various alternatives to reduce interest rate risk be considered, he determined that the other alternatives were not really appropriate or feasible. R.D. at 70.

The ALJ also addressed the requirements of the FDIC Policy Statement. Although most aspects of the FDIC Policy Statement were incorporated in the MOU, at least one important one – the establishment of internal controls, segregation of duties, and internal audit programs to prevent unauthorized trading – is not expressly addressed in the MOU. The ALJ found that Mr. Rullman's

"dominant role in the trading of futures is a matter of legitimate concern to examiners" in light of the FDIC Policy Statement. R.D. at 44. Despite the lack of segregation of duties and internal controls and audit programs, the ALJ found that "futures trading confined to top management, subject to constant oversight by the board [of directors]," to adequately effect the FDIC Policy Statement's requirements that some form of check be established on Mr. Rullman's role. R.D. at 45. In addition, the ALJ concluded that literal application of the requirement was not necessary because it was aimed at larger banks where futures trading was conducted by lower level employees and, in any event, was impossible because of the size of the Bank. R.D. at 44, 45.[15]

DISCUSSION

In its Exceptions, FDIC Enforcement Counsel asks the Board to reverse the ALJ's Recommended Decision and impose a cease and desist order on the Bank pursuant to 12 U.S.C. § 1818(b).[16] It is clear to the Board that some of

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[15] With regard to the liquidity issue, the ALJ, although noting the low percentage of short term assets to short term volatile liabilities, concluded that liquidity did not present a great danger to the Bank because of the availability of the appreciated securities and the Bank's stable deposit base. R.D. at 91.

[16] FDIC Enforcement Counsel, while agreeing with a significant number of the ALJ's factual findings in its Exceptions, expressed disagreement with some factual findings as well as with some of the ALJ's inferences and conclusions. Detailed discussion of the Exceptions would serve no purpose in light of the Board's disposition of this case.

the Exceptions are well-taken and that the Bank is not in full compliance with the MOU and FDIC Policy Statement (this point is not really disputed by the ALJ).

The Board's decision whether or not to impose a cease and desist order based on the Bank's shortcomings involves the exercise of discretion. A cease and desist order is remedial in nature. It is not intended to punish the subject respondent, but rather, to enforce the need for correction of unsafe and unsound practices. In this case, the Board believes, for the reasons stated below, that the ALJ erred in recommending that the discretion be exercised in favor of not imposing some type of cease and desist order.

The Board agrees with much of the ALJ's analysis. It is clear that the Bank chose the right vehicles – short T-Bill and Eurodollar futures – for its hedge and accomplished at least a partial hedge. It is equally clear that the naked call options, spread positions and REMIC investment were not part of the hedging program but caused no loss to the Bank. Moreover, Mr. Rullman appears to have significant familiarity with the securities and futures markets and gave some consideration to these investments prior to engaging in them, even though the Board concludes that some were speculative in nature.

Finally, the Bank did make some effort to comply with the MOU and FDIC Policy Statement. The Bank did initially attempt to address the interest rate risk problem after the February 1991 examination by putting into place the Policy and engaging in hedging transactions beginning in September 1991. At about the time the MOU was signed in February 1992, the Bank had begun to and

continued thereafter to make an attempt to comply with its provisions. It adopted the Policy Management Statement which represented a significant improvement over the Policy. It put the ALCO in place and held regular meetings at which the ALCO received important information concerning the Bank's current futures positions and their correlation with the liabilities the Bank was hedging.

The Bank also began to obtain assistance with its hedging program from outside professionals. In December 1991, KMPG Peat Marwick performed a correlation analysis showing the high correlation between the hedge instruments the bank chose and the liabilities the Bank was hedging. It received further information on its interest rate risk and hedging from IBAA Securities in June 1992.

Finally, the Bank's records do contain information on how it determined the size and nature of some of its futures positions. Thus, the Bank has made progress in addressing the interest rate risk issue.

Nonetheless, this progress should not obscure the haphazard and after-the-fact nature of compliance with the MOU and FDIC Policy Statement and the problems that remain. As discussed below, this case illustrates some of the issues and potential problems with partial compliance with the MOU and the FDIC Policy Statement. Investing in futures entails significant risks. In this case, for example, one position – the naked call options – was completely speculative and exposed the Bank to the risk of substantial losses. The investment in spread positions was also essentially speculative although it exposed

the Bank to somewhat less risk than the naked call options.

In the context of these risky investments, the MOU and FDIC Policy Statement serve two purposes. One is substantive: ensuring that an institution has given careful consideration to all relevant factors prior to making these investment decisions. The other is procedural in the sense of recordkeeping: ensuring that examiners, auditors, and persons within a financial institution are able to ascertain the steps in the decisionmaking process in order to review the appropriateness of the transactions. In addition to the suitability of these investments, there are three critical areas of inquiry: prior approval, documentation, and segregation of duties.

Ultimately, the requirements at issue in this case are analogous to the requirements that apply when a financial institution makes a loan or any other investment: to carefully consider the merits of the investment, to properly document the decisionmaking process, and to have compliance personnel verify these steps. An institution would no more make a loan to a borrower without first considering the borrower's ability to repay, documenting that consideration, and having some independent check on those functions, than it would make an investment in futures for the purpose of hedging without ascertaining and documenting the extent of interest rate risk, and subjecting those calculations to independent verification by auditing personnel. To endorse the Bank's conduct in this case would be to endorse something less than the "prudent person" standard of care required of bankers. This the Board declines to do.

A. Deficiencies in Prior Approval and Documentation

The facts of this case highlight the problems in the Bank's decisionmaking process in effecting its futures investments. Essentially, two problem areas remain: rigor of prior analysis and proper documentation. From the facts, it appears that Mr. Rullman made the crucial decisions on his own, without complete analysis or documentation and, at times, without prior approval by the ALCO and the board. For example, the Bank acquired the first futures on September 9, 1991, yet the February 23, 1992, ALCO minutes are the earliest document in the record purporting to show the calculations justifying the 80 contracts acquired in September 1991. Moreover, none of the ALCO or board minutes justify the naked call options sold at about the same time.

Furthermore, in the fall of 1992, the Bank began to acquire a number of spread positions. However, there is no documentation of approval of such investments prior to the ALCO minutes for March 29, 1993, and, the only document explaining the strategy is undated (Ex. 21-b-5). Despite the ALJ's finding to the contrary, R.D. at 101, the Board cannot agree that the Bank's policies specifically authorized acquisition of long contracts prior to the approval contained in those minutes. Neither the Policy (Ex. 16-b-2) nor the Policy Management Statement (Ex. 15, pp. 9-15) specifically authorizes acquisition of long futures or, indeed, the acquisition of futures for any purpose except reduction of interest rate risk. Moreover, to the extent that these documents contain language that is vague enough to be interpreted as permitting the acquisition of long futures, the Board deems these documents

not to be in compliance with the FDIC Policy Statement's specificity requirements. *See* 45 Fed. Reg. at 18117-118.[17]

In addition, there were changes and increases in the number of futures contracts held despite indications of a decrease in the Bank's interest rate risk exposure. The Bank's records do not disclose any analysis or calculations showing the basis for these decisions. The Board also notes that at least one ALCO member was unclear concerning the reason for the increases.

Indeed, in this regard, it is significant, in the Board's view, that at no time until just before the hearing did the Bank perform calculations of its own to quantify its interest rate risk exposure. The ALJ excused this failure because the Bank received gap analyses measuring that exposure from FDIC and State examiners, R.D. at 39, as well as from IBAA. The existence of these sporadic analyses plainly furnished the Bank important information, but the Board disagrees that the Bank's receipt of these analyses absolves it. In the same way that the Bank, on a regular basis, was monitoring the correlation between the liabilities it was hedging and the hedge instruments, it should also have been monitoring its interest rate risk

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[17] The "net" number of contracts (short minus long) has tended to remain at the basic hedge position of approximately 80 short. This net position, however, is not the same as merely having 80 short contracts in place because the long contracts had different maturities from the additional short contracts. Accordingly, a policy merely permitting the Bank to acquire 80 short contracts to hedge interest rate risk would not also justify, without more, a position of 160 short and 80 long contracts because the second position involves considerations other than hedging interest rate risk.

exposure. The need for more regular monitoring is borne out by the fact that its interest rate risk exposure declined during the period at issue without the Bank making a determination concerning the advisability of adjusting its futures positions. Moreover, if the Bank objected to using gap analysis as too simplistic, it was free to choose any other acceptable method of measuring the risk.[18] The important point was to make sure that the risk was measured regularly in some fashion.

Finally, the ALJ incorrectly excused what can be described as Mr. Rullman's very cursory analysis of the REMIC investment. R.D. at 48-50. Even though Mr. Rullman may have performed some analysis prior to the purchase, R.D. at 49-50, several cryptic notes written on a prospectus, while they appear to address questions concerning the appropriateness of the investment, do not constitute adequate contemporaneous documentation concerning a security that under certain circumstances might be an improper investment under federal guidelines, *supra* note 12.

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[18] Just prior to the hearing, Mr. Rullman performed some calculations of interest rate risk (Ex. 268A, 268B, 268C) as well as an interest rate risk analysis relying on a framework proposed in *Risk Based Capital Standards: Interest Rate Risk*, 58 Fed. Reg. 48206 (Sept. 14, 1993). R.D. at 16-19; Tr. 831. While FDIC Enforcement Counsel has pointed out that the method of analysis proposed in the Federal Register has not yet been finally approved, R.D. at 18-19, if the FDIC and the Bank can agree that the method is appropriate and works, there is no reason it cannot be used. In addition, the Board understands that computer software to perform more sophisticated analyses is readily available.

In sum, despite the Bank's adherence to aspects of the MOU and the FDIC Policy Statement, the Board finds deficiencies in its approval and documentation of its futures transactions. Ultimately, it is difficult for the Board to determine what formal analysis went into the decisions made by the Bank or how, after the initial decision to acquire 80 short contracts, subsequent contracts fit into the policies adopted by the Bank.[19]

The formal requirements of the FDIC's policies and the MOU are not particularly onerous. Prior to a futures transaction, the Bank needs to fully document the decision. At a minimum such documentation must indicate how the transaction is justified by the Bank's policies concerning interest rate risk (or must indicate board approval if the transaction does not fit within the current policies), what the extent of the interest rate risk is, how the size of the transaction is calculated, and how the particular futures contracts are chosen, *i.e.*, the correlation with the liabilities or assets to be hedged. The Bank should be carefully considering these issues prior to the transactions in any event, so reducing them to writing should not be difficult. Indeed, the record contains documents presenting much of this information after the fact.

The Board notes that the prior approval and documentation requirements in the MOU and the FDIC Policy

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[19] This is not to say that the original policies adopted need to foresee every possible futures investment and explain the circumstances under which the Bank may choose that investment or that they can be so vague as to be meaningless. The policies can and must change, and the use of futures should vary with changes in the Bank's interest rate risk exposure.

Statement are crucial to well-informed decisionmaking. They are also important because they permit FDIC examiners and others to evaluate the prudence of the decisions made based on contemporaneous documentation. The failure to adhere closely to these requirements is an unsafe and unsound practice that exposes the Bank to an abnormal risk of loss. Therefore, the Board cannot condone that failure.[20]

B. The Separation of Duties Problem

The problems previously noted in the prior approval and documentation areas take on added significance in this case because of another problem: the concentration of duties in the hands of Mr. Rullman. The ALJ noted this as a legitimate area of concern, but concluded that given the Bank's size and its Board's continuing supervision of these futures activities on a monthly basis, the Bank satisfied, to the extent possible, the requirements of the FDIC Policy Statement that there be an independent review of the decisions made by Mr. Rullman.

Since the issuance of the ALJ's Recommended Decision in October 1994, the international banking community has witnessed a very graphic example of the dangers of concentrating duties related to futures trading in the hands of a single person. One factor in the failure of Barings Bank, PLC, was the concentration of trading,

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[20] The Bank's ability to protect itself using futures was not really tested during the period at issue because of the relatively stable interest rates. It is unclear how the Bank would have fared in a period of more volatile rates.

settling, and compliance duties in a single employee in Barings' Singapore office.

In light of this graphic experience of a violation of the requirements of sound banking practice as set forth in the FDIC Policy Statement, the Board must be particularly sensitive to the added risk presented by the lack of segregation of duties. It would be preferable for the Bank to have more than one person with expertise in the area of futures activities to ensure an independent check on the person conducting those activities. However, the Board realizes that in a small bank it may not be practical to have more than one person with expertise in this area.

Accordingly, the Board will not impose any additional requirements at this time beyond the current mechanism of board review of and responsibility for futures market activities at the Bank. However, the Bank must remember that adhering closely to the MOU and the FDIC Policy Statement concerning prior approval and documentation takes on added significance because the board's ability to perform its oversight function will depend on the information provided to it.

CONCLUSION

For the foregoing reasons, the Board disagrees with the ALJ that the Bank's compliance with relevant requirements is substantially complete and that a cease and desist order is not warranted at this time.[21] In the Board's

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[21] On the liquidity issue, the Board essentially agrees with the ALJ that the presence of a stable deposit base, the readily

view, the failures of compliance in this case constitute violations of the MOU and FDIC Policy Statement as well as unsafe and unsound practices which could threaten the Bank with an abnormal risk of loss. Accordingly, the Board deems it appropriate to issue the following cease and desist order. The purpose of this order is simply to require complete compliance with the MOU and FDIC Policy Statement.

ORDER

It is hereby ORDERED AND DECREED that:

1. Within 30 days of the date this Decision and Order is received by the Bank, the Bank shall furnish documents to the FDIC showing full compliance with the MOU and FDIC Policy Statement. Those documents shall include:

a. The most recent document approved by the ALCO and board governing the Bank's policy for dealing with interest rate risk exposure;

b. Documents showing any futures positions the Bank holds; and

c. Documents explaining how the futures positions are justified by the policy for dealing with interest rate risk exposure including the calculations performed for determining the extent of

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marketable appreciated securities and the lines of credit with other banks render less threatening the mismatch of long term assets and short term volatile liabilities at the Bank. However, it is imperative that the Bank continue to closely monitor its liquidity position. Any change in the status of the securities or the lines of credit could adversely effect that position.

interest rate risk exposure, the number of contracts and the correlations justifying the choice of futures contracts.

2. The Bank shall continue to comply with the MOU and FDIC Policy Statement and shall calculate interest rate risk exposure on a quarterly basis using gap analysis or any other method of analysis on which the FDIC and the Bank can agree.

By direction of the Board of Directors, dated at Washington, D.C., this 1st day of August, 1995.

/s/ Jerry L. Langley
Jerry L. Langley
Executive Secretary

(Seal)